

## **CSA Publishes Proposed National Instrument 94-101 – Mandatory Central Counterparty Clearing of Derivatives**

On February 12, 2015, the CSA released for public comment a proposed rule on the subject of mandatory central counterparty (CCP) clearing of over-the-counter (OTC) derivatives in Canada. The Clearing Rule sets out the requirements for implementing in Canada the G20 commitment to require that all standardized OTC derivatives be cleared through CCPs.

The Clearing Rule is in the form of a National Instrument that will be applied across all jurisdictions in Canada, in contrast to the trade reporting rules which are different across the country and are in various stages of implementation. The Clearing Rule has been shaped by comment letters received by the CSA in response to the draft model rule that was previously published in 2013.

The Clearing Rule is divided into two key rule-making areas:

- rules for mandatory CCP clearing (including proposed end-user and intragroup exemptions)
- rules for determining appropriate OTC derivatives to be mandated for CCP clearing (each a "mandatory clearable derivative")

### **Mandatory clearing and timing requirements**

A local counterparty to a transaction involving a mandatory clearable derivative has the duty to submit the transaction to a recognized clearing agency by the end of the day on which the transaction was executed. If the transaction is executed after business hours of the clearing agency, the transaction must be submitted for clearing on the following business day.

Some comment letters raised concern that there may not be sufficient time to clear a transaction before the end of the day if that transaction is executed shortly before the clearing agency closes. The CSA did not accept this as an issue where straight-through processing is implemented and no change was made to the timing requirement.

**A local counterparty to a transaction involving a mandatory clearable derivative has the duty to submit the transaction to a recognized clearing agency by the end of the day on which the transaction was executed.**

### **Who is a local counterparty?**

A "local counterparty" is a person that, at the time of the transaction, meets the following criteria:

- (a) the counterparty is a person or company that is organized under the laws of the local jurisdiction or has its head office or principal place of business in the local jurisdiction, or
- (b) the counterparty is an affiliated entity of a person or company described in (a) and such person or company is responsible for the liabilities of the counterparty.

Note the definition of local counterparty is not the same as in the trade reporting rules in that it does not include an entity that is registered or exempt from registration under securities legislation in Canada.

### **Substituted Compliance**

The Clearing Rule creates overlapping international and interprovincial clearing requirements. The CSA permits substituted compliance in limited circumstances. Substituted compliance is only available to an entity that is a local counterparty under branch (b) of the definition. In order to rely on substituted compliance, the transaction must be submitted for clearing under the laws of another Canadian jurisdiction (only applies to Newfoundland and Labrador, NWT, Nunavut, PEI and Yukon) or the laws of specified foreign jurisdictions. Such foreign jurisdictions will be listed on an Appendix to the final Clearing Rule and, in Quebec, on a published list.

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## What is a mandatory clearable derivative?

A "mandatory clearable derivative" is defined as a derivative that the regulators determine to be subject to the clearing requirement. The process for making that determination is as follows:

### STEP 1

A regulated clearing agency will be required to notify the regulators of each OTC derivative for which it provides clearing services.

### STEP 2

The regulators will then identify whether the cleared OTC derivative should be made a mandatory clearable derivative, based on factors such as standardization of the derivative, its risk profile, and the liquidity and characteristics of its market.

### STEP 3

The regulators will then publish for comment each derivative that is proposed to be a mandatory clearable derivative

### STEP 4

Derivatives subject to mandatory clearing will be listed on an Appendix to the final Clearing Rule

## Exemptions from the mandatory clearing requirement

### i. end-user exemption

Mandatory clearing will not apply if one of the counterparties is entering into the transaction to hedge or mitigate commercial risk and is not a "financial entity."

The availability of this exemption is limited by the broad definition of "financial entity", which includes a Canadian and foreign bank, trust company, loan company, insurance company, cooperative credit association, credit union, caisse populaire, treasury branch, financial services cooperative, pension fund, investment fund, and entities registered or exempt from registration under securities legislation of a jurisdiction of Canada.

Many comment letters raised concerns that the definition of "financial entity" should not include, for example, small financial institutions, investment funds and pension funds. The CSA made no change in response to these concerns.

The Clearing Rule includes a definition of "hedging or mitigating commercial risk". The derivative must establish a position which is intended to reduce risks relating to the commercial activity or treasury financing activity of the counterparty or of an affiliate, and, alone or in combination with other derivatives, directly or through closely correlated financial instruments, and meets the criteria described in the rule. Such position must not be held for a purpose that is in the nature of speculation, or to offset or reduce the risk of another derivative transaction. The CSA provides helpful guidance on the interpretation of hedging or mitigating commercial risk.

### ii. intragroup exemption

To qualify as an intragroup transaction, the counterparties must be prudentially supervised on a consolidated basis or their financial statements prepared on a consolidated basis. The counterparties to the intragroup transaction must agree to rely on the exemption, the transaction must be subject to appropriate centralized risk evaluation, and there must be a written agreement setting out the terms of the transaction. The local counterparty relying on the exemption must file an intragroup exemption form within 30 days of reliance on the exemption, which remains valid for one year, subject to a 10-day reporting requirement of any material change.

## Transactions with governments and government entities

The mandatory clearing requirement does not apply to Canadian and foreign governments, crown corporations whose obligations are guaranteed by their constituting government, wholly owned government entities whose obligations are guaranteed by their constituting government, central banks, and BIS. The clearing requirement does not apply even if the other counterparty is otherwise subject to it.

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## Phase-in of mandatory clearing requirement

The CSA proposes to phase-in the clearing requirement according to different categories of market participants, as follows:

<b>FIRST PHASE</b>	at the time the regulator determines a derivative to be a mandatory clearable derivative, clearing members of a regulated clearing agency that provide clearing for such mandatory clearable derivative
<b>SECOND PHASE</b>	6 months after the regulator determines a derivative to be a mandatory clearable derivative, financial entities above a certain threshold (which is yet to be determined)
<b>THIRD PHASE</b>	12 months after the regulator determines a derivative to be a mandatory clearable derivative, all other financial entities
<b>FOURTH PHASE</b>	18 months after the regulator determines a derivative to be a mandatory clearable derivative, all other counterparties that are not financial entities

## What's next?

The CSA will next consider the comment letters received in response to the proposed Clearing Rule and make changes, if any. The CSA anticipates that the final Clearing Rule will be in force in Canada in Q4 2015 or Q1 2016.

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